

OP:E:EO:T:3

MAR 30 1999

Internal Revenue Code: 501(c)(15)  
Employer Identification Number: [REDACTED]  
Key District: [REDACTED]  
Accounting Period Ending: December 31  
Form 990 Required: Yes  
Effective Date of Exemption: [REDACTED]

Dear Taxpayer:

This refers to your application for recognition of exemption from federal income tax as an organization described in section 501(c)(15) of the Internal Revenue Code.

The information furnished shows that you were incorporated under the laws of [REDACTED]. You have elected under section 953(d) to be treated as a domestic insurance company for all purposes of the Internal Revenue Code.

The information furnished shows that [REDACTED] was your sole shareholder until [REDACTED]. Effective [REDACTED], you have been owned by [REDACTED] (50%) and by [REDACTED] (50%). [REDACTED] and [REDACTED] are husband and wife. The vehicle service contracts reinsured by you are sold by [REDACTED]. [REDACTED] is the sole shareholder of [REDACTED].

The dealership markets the "[REDACTED]" for warranty coverage for new and used cars. The [REDACTED] provides specifically that the dealer is liable for repairs, that [REDACTED] is the administrator and that proceeds from the customer must be used to purchase insurance from [REDACTED] to indemnify the cost of repairs. The selling dealer's obligation to perform under the agreement is insured by [REDACTED]. If the selling dealer fails to perform in 60 days from the date of notice after a proof of loss covered by the service agreement then the customer may make a direct claim against [REDACTED].

[REDACTED] requires that the dealership collect from the listed customers specific amounts to handle anticipated claims, and that these amounts be invested and maintained as reserves to handle

claims. [redacted] directs these reserves for anticipated claims to [redacted], an insurance company owned and operated by [redacted]

You advise that [redacted] reinsures its risks under the [redacted] with you. Under a reinsurance contract entered into between you and [redacted], [redacted] reinsures with you [redacted] of automobile single interest insurance contracts issued to customers of [redacted]

Based on information supplied, and assuming your operations will be as stated in your application for recognition of exemption, we have determined you are exempt from federal income tax under section 501(a) of the Internal Revenue Code, as an organization described in the section indicated above, effective [redacted], for tax year(s) when your net written premiums (or, if greater, your direct written premiums) do not exceed the \$350,000 limit as prescribed by this section.

Unless specifically excepted, you are liable for taxes under the Federal Insurance Contributions Act (social security taxes) for each employee to whom you pay \$100 or more during the calendar year. Unless excepted, you are also liable for tax under the Federal Unemployment Tax Act for each employee to whom you pay \$50 or more during a calendar quarter if, during the current or preceding calendar year, you had one or more employees at any time in each of 20 calendar weeks or you paid wages of \$1,500 or more in any calendar quarter. If you have any questions about excise, employment, or other federal taxes, please contact your key district office.

If your sources of support, or your purposes, character, or method of operation change, please let your key district know so that office can consider the effect of the change on your exempt status. In the case of an amendment to your organizational document or bylaws, please send a copy of the amended document or bylaws to your key district. Also, you should inform your key district office of all changes in your name or address.

In the heading of this letter we have indicated whether you must file Form 990, Return of Organization Exempt from Income Tax. If "Yes" is indicated, you are required to file Form 990 only if your gross receipts each year are normally more than \$25,000. If your gross receipts each year are not normally more than \$25,000, we ask that you establish that you are not required to file Form 990 by completing Part I of that Form for your first year. Thereafter, you will not be required to file a return until your gross receipts exceed the \$25,000 minimum. For guidance in determining if your gross receipts are "normally" not more than the \$25,000 limit, see the instructions for the Form

990. If a return is required, it must be filed by the 15th day of the fifth month after the end of your annual accounting period. A penalty of \$20 a day is charged when a return is filed late, unless there is reasonable cause for the delay. The maximum penalty charged cannot exceed \$10,000 or 5 percent of your gross receipts for the year, whichever is less. For organizations with gross receipts exceeding \$1,000,000 in any year, the penalty is \$100 per day per return, unless there is reasonable cause for the delay. The maximum penalty for an organization with gross receipts exceeding \$1,000,000 shall not exceed \$50,000. This penalty may also be charged if a return is not complete, so please be sure your return is complete before you file it.

You are required to make your annual return available for public inspection for three years after the return is due. You are also required to make available a copy of your exemption application, any supporting documents, and this exemption letter. Failure to make these documents available for public inspection may subject you to a penalty of \$20 per day for each day there is a failure to comply (up to a maximum of \$10,000 in the case of an annual return).

You are not required to file federal income tax returns unless you are subject to the tax on unrelated business income under section 511 of the Code. If you are subject to this tax, you must file an income tax return on Form 990-T, Exempt Organization Business Income Tax Return. In this letter we are not determining whether any of your present or proposed activities are unrelated trade or business as defined in section 513 of the Code.

Contributions to your organization are not deductible by donors under section 170(c)(2) of the Code. Under section 6113, any fund-raising solicitation (including a solicitation for membership dues payment) you make must include an express statement (in a conspicuous and easily recognizable format) that contributions and gifts are not deductible as charitable contributions for federal income tax purposes. This does not apply, however, if your annual gross receipts are normally \$100,000 or less, or if your solicitations are made to no more than ten persons during a calendar year. The law provides penalties for failure to comply with this requirement, unless the failure is due to reasonable cause. See Internal Revenue Service Notice 88-120, 1988-2 C.B. 454, for additional information.

You need an employer identification number even if you have no employees. Please use that number on all returns you file and in all correspondence with the Internal Revenue Service.

[REDACTED]

With respect to the period prior to [REDACTED], we find that you are not an insurance company or association other than life, and your application for recognition of exemption under section 501(c)(15) of the Code is denied for reasons set forth below.

#### LAW AND ANALYSIS

Section 501(c)(15) provides that "[i]nsurance companies or associations other than life" are exempt from taxation under § 501(a) if "net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed \$350,000." § 501(c)(15)(A).

The principal test for what constitutes "insurance" for federal income tax purposes is set out in Helvering v. Le Gierse, 312 U.S. 531 (1941). In that case, the Supreme Court stated that "[h]istorically and commonly insurance involves risk-shifting and risk-distributing." Id. at 539. Further, the Court stated that this risk must be an "insurance risk" as opposed to an "investment risk." Id. at 542. In Allied Fidelity Corp. v. Commissioner, 66 T.C. 1068, 1074 (1976), aff'd, 572 F.2d 1190 (7th Cir. 1978), the Tax Court wrote that this risk is a risk of "a direct or indirect economic loss arising from a defined contingency," so that an "essential feature of insurance is the assumption of another's risk of economic loss."

Rev. Rul. 77-316, 1977-2 C.B. 53, addressed three situations in which a domestic corporation and its domestic subsidiaries paid amounts, designated as insurance premiums, directly or indirectly to the parent's wholly owned foreign "insurance" subsidiary. In Situation 1, the parent and its subsidiaries paid amounts directly to the insurance subsidiary. In Situation 2, the parent and its subsidiaries paid amounts to M, an unrelated domestic insurance company, under a contractual arrangement providing that M would remain as the primary insurer but immediately "reinsure" 95 percent of the risks received with the parent's insurance subsidiary. In Situation 3, the parent and its subsidiaries paid amounts directly to the insurance subsidiary, but the insurance subsidiary then transferred 90% of the risks to W, an unrelated insurance company, in a reinsurance transaction. The ruling noted that, in all situations, the insurance subsidiary and the parent's other subsidiaries were under the common control of the parent. In no situation did the insurance subsidiary accept risks from parties other than the parent and its domestic subsidiaries.

Rev. Rul. 77-316 concluded that the arrangements in each of these situations under which the insurance subsidiary assumed "a

portion of the risks" of the parent and its domestic subsidiaries were "not insurance under the standards set forth in Le Gierse." Id. at 55. It held that the subsidiaries were "not insurance companies ... because their primary and predominant business activity [was] not the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by other insurance companies. Id. at 56.

Following Rev. Rul. 77-316, other revenue rulings placed importance on the captive insurer and the insured as being, or not being, under common control. In Rev. Rul. 78-338, 1978-2 C.B. 107, 31 unrelated shareholders owned a corporation from which they purchased insurance; no shareholder's individual risk could exceed 5% of the total risks insured by the company. The ruling stated that "[n]o shareholder own[ed] a controlling interest in the insurance company," and concluded that, "because the taxpayer and the other insureds-shareholders are not economically related," the arrangement would be treated as insurance for federal income tax purposes. In Rev. Rul. 83-172, 1983-2 C.B. 107, 40 employers formed a insurance exchange for the purpose of insuring their liability under the state workmen's compensation law. No single employer in the group provided more than 5 percent of the total risk insured by the fund. The ruling found that the members of the group were not "economically related or commonly controlled." Id. It held that the fund would be treated as an insurance company other than a life insurance company for federal income tax purposes. Id. at 108.

Your sole business is indemnifying the risks of your owner's automobile dealership under service contracts on which the dealership is liable. Both you and the dealership are under the common control of the same majority shareholder. Your business is substantially similar to that of the company in Situation 2 of Rev. Rul. 77-316. Based on the foregoing, we rule that you are not an insurance company or association other than life, and your application for exemption under section 501(c)(15) of the Code is denied for the period prior to [REDACTED].

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days of the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need you to

[REDACTED]

file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

You will expedite our receipt of your protest statement by using the following address on the envelope:

OP:B:EO:T:3, Room 6137, Attn: [REDACTED]  
Internal Revenue Service  
1111 Constitution Ave., NW  
Washington, D.C. 20224

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to the Southeast key District Office, which is located in Baltimore, Maryland. Thereafter, any question about your federal income tax status should be addressed to that office. Thank you for your cooperation.

Sincerely,

151

Robert C. Harper, Jr.  
Chief, Exempt Organizations  
Technical Branch 3

OP:G:EO:T:3

OP:E:EO:T:3